



Economic Update

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Economy Gains Momentum

A steady stream of positive economic data shows that the U.S. economy is growing at a faster pace. Real growth in gross domestic product [GDP] was a stronger-than-expected 3.1 percent at an annual rate in the second quarter – revised up from the earlier estimate of 2.4 percent – and forecasters now expect the growth rate to be higher than 4 percent in the second half of this year. The improved outlook is occurring across the board, with tax relief helping to boost households' consumption spending and business investment spending. Higher government defense spending also has contributed to short-run GDP growth.

The one lagging area is the performance of payroll jobs. Despite a falling unemployment rate and an increase in the total number of persons employed in the economy (also reflecting the improving outlook), the estimates of business payroll employment have continued to show declines in jobs. But at this point of the business cycle, the payroll jobs estimates should be interpreted cautiously: past experience with the initial, preliminary jobs estimates has shown them to be less reliable at measuring job-market strength when the economy is in the early stages of expansion following a recession.

Data Point to Stronger Economy

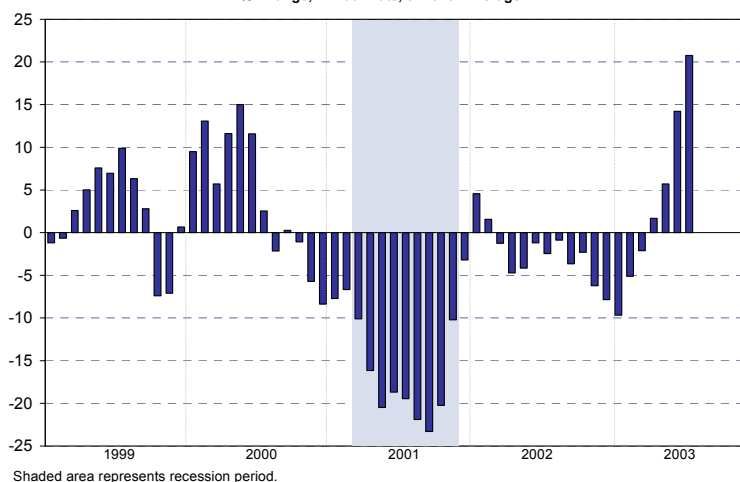
Most economic data from the past several months point to an improving economy, with many reflecting the beneficial effects of the Jobs and Growth Tax Relief Act signed into law in May.

- Disposable personal income (after-tax income) surged 1.5 percent in July – reflecting the initial effects of this year's tax cuts and advance payments for higher child tax credits. Personal consumption spending increased 0.8 percent and the saving rate rose to 3.8 percent in July from 3.1 percent in June. The reduction

in Federal income taxes in July was \$3.8 billion for withheld taxes and \$4.6 billion for the child tax credit checks. Without the tax cut real personal disposable income would have been flat in July; estimates indicate that real consumption spending would have been flat to down slightly instead of rising 0.6 percent. Rough estimates suggest that slightly more than half of the tax cut in July was spent that month.

- The “bonus depreciation” for business equipment and software spending has helped boost business investment; producers' durable equipment and software investment spending rose 8.2 percent at annual rate in the second quarter – its highest rate in 3 years. Orders and shipments of manufacturers' durable goods have surged in recent months. Shipments of manufacturers' nondefense capital goods (a key measure of business investment) are rising at double-digit annual rates recently (see chart below), pointing to strong investment growth in the third quarter.

MANUFACTURERS' SHIPMENTS, NONDEFENSE CAPITAL GOODS
% Change, Annual Rate, 3-Month Average



- Manufacturing production activity is at its highest level since 1999, and the last time it was higher was in 1997 – according to data from the Institute for Supply Management manufacturing purchasing managers index. The ISM *nonmanufacturing* index rose to 65.1, its highest level on record in July and August – and up from a recent low of 47.9 in March. (A figure greater than 50 means the sector is expanding.)

Other factors remain slightly less clear:

- Consumer sentiment and confidence have shown mixed behavior in recent months, but remain higher than earlier this year, and at levels historically consistent with moderate economic growth.
- Housing starts and sales continue at historically high levels despite recent increases in mortgage rates. In contrast, business construction has been flat over the past year following significant declines over the previous 2 years.

The broad increases in economic data across manufacturing, investment, income and consumption bode well for real GDP growth in the third quarter and beyond. The July income and consumption data suggest that real consumption spending – which accounts for two-thirds of GDP – is on track to rise at an annual rate of 4 percent to 5 percent in the third quarter.

Falling Unemployment and Questionable Jobs Data

The unemployment rate fell to 6.1 percent in August from 6.2 percent in July but nonfarm payroll employment fell by 93,000 jobs in August. It is important to recognize that the unemployment rate and the payroll jobs estimates are determined from two different surveys:

- The payroll jobs numbers are determined from the “establishment survey” that is determined from business reports on the number of jobs they have on their payrolls. The survey results can be affected by businesses failing or by new business startups that do not initially report to the establishment survey.
- The unemployment rate is determined from the “household survey” in which individuals are asked

directly whether they are actively in the labor force and whether they are employed or looking for work. Some may report, accurately, that they are employed, even though their jobs do not fit in the categories of the establishment survey.

The two different surveys can therefore potentially show different results on employment. Historical evidence indicates that the nonfarm payroll jobs numbers from the establishment survey tend to be biased downward at times such as now – when the unemployment rate is falling, household employment is rising, and the economy is in an early expansion.

Blue Chip Economic Outlook, September 2003

	2003.1	2003.2	2003.3	2003.4	2004.1	2004.2	2004.3	2004.4
	--- History ---				----- Projection -----			
Real GDP Growth	1.4	3.1	4.5	3.9	3.9	3.7	3.8	3.6
Unemployment Rate	5.8	6.2	6.2	6.2	6.0	5.9	5.9	5.8
CPI Inflation	3.8	0.7	1.8	1.6	1.8	1.9	2.0	2.1
3-month Treasury Bill	1.2	1.0	1.0	1.0	1.1	1.3	1.6	2.0
10-year Treasury Note	3.9	3.6	4.3	4.5	4.6	4.7	4.9	5.0

Outlook for Stronger Growth

Following on the heels of the stronger than expected showing for the second quarter and the flow of better-than-expected economic data, private analysts expect stronger real growth over the second half of this year and through 2004. The Blue Chip forecasters now expect real GDP growth to rise to a 4.5-percent annual rate in the third quarter and to be in the 3¾-percent to 4-percent range over the next year (see table above). Inflation is expected to remain at historically low levels and interest rates are expected to rise only gradually. The unemployment rate is expected to fall gradually, declining to below 6 percent in the early part of next year.

Real GDP growth has been uneven over the past seven quarters following the modest declines experienced during the recession. The rebound in coming quarters is expected to boost growth above the economy’s estimated potential growth rate of around 3 percent. Growth faster than potential should help to bring the unemployment rate down and boost job creation.

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